

## 1. Executive summary

The aim of this paper is to **analyse the ways in which the fiscal framework can contribute to achieving one of the major goals of current economic policy: increasing the competitiveness of the Spanish economy.** The transfer of monetary policy competence to the ECB and the establishment of a European system for budgetary coordination have made the tax system a key instrument for improving competitiveness.

The present paper contains a proposal for **strategies that would broach the problems surrounding competitiveness from a taxation perspective**, while taking into consideration not only the overall tax burden weighing on the Spanish economy but also, and especially, the tax structure in relation to the main production factors: capital, in its dual dimensions of saving and investment, and labour.

Problems as significant as the inadequacy of national saving (and its correlate, the dependence on financing inflows from the rest of the world and the corresponding current-account deficit) and the concentration of investment in a very specific industry must be addressed in taxation-related decisions. **Therefore, the taxation framework cannot be divorced from general economic policy.**

**In this regard, the tax reform now in the legislative process seems to be a wasted opportunity to contribute to solving the problem of competitiveness.**

**This is the case of the inadequacy of private saving.** As evidenced by the very high current-account deficit in the Balance of Payments, there is a substantial imbalance between savings and investment flows in Spain, which is leading the country to greatly increase its dependence on financing from abroad. This inadequate national saving is especially worrying in light of a series of considerations: first, the fact that monetary policy decisions (which so greatly affect the cost of financing these flows) do not revolve around the specific needs of Spain's economy; second, the decrease in household saving, which has traditionally financed other sectors; third, the ageing of the population, which is not being adequately addressed through greater long-term financial saving, even though it will affect this country especially acutely.

In light of this situation, **fiscal legislation** (in an environment where capital is allowed to circulate freely) **has a clear scope of action, in the framework of comparative law in this regard**, the aim being a distinct improvement in the taxation of saving in general, and long-term saving in particular. These are the concerns that should characterize the application of the principle of neutrality in the tax treatment of saving.

In contrast to this position, **the reform that is currently before Parliament does not seem to meet this necessary objective of encouraging saving**, inasmuch as several of its provisions run counter to this aim. One prime example, in the case of the Personal Income Tax, is the higher tax rate to be applied to savings income, not to mention the more unfavourable treatment of long-term savings (through the change in the way benefits from pension plans received in the form of capital are treated, or the establishment of common limits for individual and corporate plans) and the change in the tax treatment of dividends. Furthermore, this reform does not capitalize on the opportunity to eliminate the Wealth Tax which, apart from being unusual in the framework of the EU, clearly discourages saving. Nor does the elimination in the Corporation Tax of the reduction in taxation for reinvestment of capital gains appear to pursue the aim of encouraging saving (in this case, business saving).

Another issue of concern in the Spanish economy which should also be addressed from a taxation perspective is the evolution of investment from a dual vantage: On the one hand, the **concentration of national investment** in a very specific industry—**construction**—and the vulnerability generated in terms of growth, job creation and households' financial situation; and on the other the **need to improve Spain's relative position in the very competitive market of international investment flows**.

The taxation framework can undoubtedly contribute to balancing the areas of national investment by eliminating the current bias that favours the purchase of housing (which also contradicts the stated goal of bolstering the rental housing segment). In the case of foreign direct investment, Spain's comparative tax situation is unfavourable, as its nominal and implicit tax rates are higher than those of most other European countries.

**In this respect also, the reform bill fails to take the right direction.** The differential treatment that favours investment in the purchase of a primary dwelling is maintained in the Personal Income Tax. In the Corporation Tax, the reduction in

nominal rates is slight, slow and the net result may be misleading, because of the simultaneous elimination of deductions. It is difficult to understand the elimination of the deduction for investments in R&D+I, as the furtherance of such activities theoretically plays a very important role in current economic policy, and forms a part of the fiscal framework in the vast majority of OECD countries.

The third issue discussed in this paper is **labour taxation, significant in terms of the evolution of individual productivity and that of the working population**. An excessively heavy tax burden may cause workers to reduce their participation in the labour market or even stay out of it altogether (caught in what the European Commission calls the “tax/benefit trap”). To counteract these effects, maximum and minimum nominal tax rates can be reduced, as can the number of brackets. Furthermore, horizontal equity in the treatment of this type of income should be improved, because of the concentration of the tax burden on a very specific group of taxpayers. The route taken by other developed countries (in many cases, especially by those with the strongest growth), i.e., **reducing the relative weight of revenues generated by direct taxation and replacing the latter with indirect taxation**, should be followed to prevent the revenue-generating effects of measures of this type from resulting in a worsening of the budgetary position.

The current reform provides for a very modest reduction in the marginal tax rate (which also increases the gap between the latter and that of the Corporation Tax) and in the number of brackets. This change is combined with a modification of the treatment of the minimum subsistence figure, which will create “winners” and “losers.”

In short, the **reform currently in the legislative process is a wasted opportunity**, because it is **lacking in overall strategic direction** and does not focus on resolving (or at least improving) the notorious structural problems that afflict the Spanish economy. **In addition, the quantitative results of the reform are unclear**, difficult to forecast and apparently distributed asymmetrically, and at times even arbitrarily.

Nevertheless, **as this reform is still being discussed in Parliament, it would be highly desirable to introduce provisions that would improve the competitiveness of Spain’s economy**, broadly speaking. Such provisions might include:

- Because of the obvious political difficulties involved in completely eliminating the deduction for the purchase of a primary dwelling, this deduction might be decreased in some way, for example, through a reduction in the absolute ceiling.
- A greater reduction in nominal personal income and corporation tax rates is recommended, and any widening in the gap between the two tax should be avoided.
- The changes introduced in the tax treatment of saving must be reconsidered, in particular those that involve an increase in the tax burden on insurance, as well as on pension plans and funds (whether in the case of returns in the form of capital or through deduction ceilings). The prospects on demographic ageing and the debate focusing on dependency make active fiscal stimulation of long-term saving necessary.
- The planned tax treatment of dividends should also be changed; it is difficult to comprehend in economic terms and seems to promote neither savings nor their use for financial investment.